CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

April 3, 2001

H.R. 974
Small Business Interest Checking Act of 2001

As ordered reported by the House Committee on Banking and Financial Services on March 28, 2001

SUMMARY

H.R. 974, the Small Business Interest Checking Act of 2001 (SBICA), would allow depository institutions to pay interest on business demand deposit accounts and permit the Federal Reserve System to pay interest on any reserve balances held on deposit at the Federal Reserve by insured depository institutions. The Federal Reserve Board would also be given greater flexibility in setting reserve requirements and would be required to submit an annual report to Congress summarizing many of the services provided and fees charged to consumers by depository institutions. The reduction in revenues as a result of the interest payments on reserves would be offset by transfers from surplus funds of Federal Reserve Banks to the U. S. Treasury over the next five years. Pay-as-you-go procedures would apply because the bill would affect receipts. CBO estimates that the bill would not have any net effect on annual revenues over the 2002- 2006 period because the estimated loss in revenues would be offset by transfers from Federal Reserve surplus funds. Enacting H.R. 974 would decrease revenues after 2006. CBO estimates that the loss in revenues would total approximately $1.2 billion over the 2006-2011 period.

H.R. 974 contains no intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act (UMRA) and would impose no costs on state, local, or tribal governments.

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of H.R. 974 is shown in the following table.

	By Fiscal Year, in Millions of Dollars						
	2002	2003	2004	2005	2006	2002-2006	2007-2011
CHANGES IN REVENUES							
Allowing Interest on Reserves	-125	-110	-106	-112	-117	-570	-679
Surplus Transfer to the Treasury	125	110	106	112	117	570	-570
Net Budgetary Effect	0	0	0	0	0	0	-1,249

The initial budgetary effect of SBICA would be a decrease in the payment of profits from the Federal Reserve System to the U.S. Treasury. The Federal Reserve remits its profits to the Treasury, and those payments are classified as governmental receipts, or revenues, in the federal budget. Any additional income or costs to the Federal Reserve, therefore, can affect the federal budget. The Federal Reserve's largest source of income is interest from its holdings of Treasury securities. In effect, the Federal Reserve invests in Treasury securities the reserve balances and issues of currency that constitute the bulk of its liabilities. Since the Federal Reserve pays no interest on reserves or currency, and the Treasury pays the Federal Reserve interest on its security holdings, the Federal Reserve earns profits.

By allowing the Federal Reserve to pay interest on reserves, the bill is expected to decrease the Federal Reserve's profits and thereby reduce federal revenues by $570 million over the period from 2002 to 2006. This budgetary response has several significant components. First, the Federal Reserve's payment of interest on *required reserve* balances held at Federal Reserve banks would tend to reduce governmental receipts. It is anticipated that some depository institutions and depositors would respond to the interest payments on reserves (given interest payments on business demand deposit accounts) by shifting funds out of consumer "retail" and business "wholesale" sweep accounts and into demand deposit accounts. This secondary response would increase required reserve balances and partially offset the loss in federal revenues from the payment of interest on reserves. Finally, the profits of depository institutions or their customers would increase with a consequent increase in tax revenues. That result would also have the effect of partially offsetting the decline in federal receipts. The legislation stipulates that this overall revenue loss would be offset by a transfer from surplus funds of Federal Reserve banks to the U.S. Treasury for each of the fiscal years 2002 through 2006.

BASIS OF ESTIMATE

The estimates are based on the assumption that the provisions would become effective early in fiscal year 2002, unless otherwise specified.

The Allowance of Interest on Reserve Balances

H.R. 974 would permit the Federal Reserve to pay interest on balances held on deposit at the Federal Reserve. Depository institutions hold three types of balances at the Federal Reserve–required reserve balances, contractual clearing balances, and excess reserve balances. Required reserve balances are the balances that a depository institution must hold to meet reserve requirements. Depository institutions may also hold additional balances called required or contractual clearing balances which can earn an implicit rate of interest in the form of an interest credit that is used to defray fees for Federal Reserve services. Contractual clearing balances have risen over the last decade from under $2 billion in 1990 to between $6 and $7 billion today. Excess balances are funds held at reserve banks in excess of a depository institution's required reserve and contractual clearing balances. Staff at the Federal Reserve have indicated that, given the authority, the Federal Reserve would pay interest on *required reserve* balances and give depository institutions the option of earning an explicit rate of interest on *contractual clearing* balances or continuing with the current system of earning an interest credit. The Federal Reserve would choose not to pay interest on *excess* reserve balances, unless required reserve balances fell to such a low level that interest on excess reserves was needed to build reserves. That is considered to be an unlikely scenario.

The payment of interest on *required reserve* balances is discussed first and the payment of interest on *contractual clearing* balances is discussed second, since their effect on revenues are likely to be different. Allowing the payment of interest on *required* reserve balances held by depository institutions at the Federal Reserve would shift profits from the Federal Reserve to depository institutions and reduce governmental receipts. This budgetary effect is divided into three components. First, the bill would result in the Federal Reserve paying interest on the level of its required reserve balances expected under current law, reducing its net income and, therefore, governmental receipts. Second, the payment of interest on reserves is expected to cause demand balances at depository institutions to increase. That increase would raise the level of reserve balances held at the Federal Reserve, which would invest them at a higher rate than it would pay on them. This change in projected reserves would increase governmental receipts, but only partially offset the loss caused by the payment of interest on reserves projected under current law. Third, the reduction in governmental receipts would be partially offset by increased income tax receipts. The net effect of interest payments on reserves and the anticipated shift to more demand deposit accounts would result in higher profits for depository institutions or their customers.

Allowing Interest on Reserve Balances
(By Fiscal Year, in Millions of Dollars)

	2002	2003	2004	2005	2006	2002-2006	2007-2011
			CHANGES IN REVENUES				
Revenue from Federal Reserve:							
Interest on Required Reserves	-185	-194	-204	-214	-224	-1,021	-1,300
Profits from Increased Reserves	18	48	62	65	68	261	395
Net Revenue Effect	-167	-146	-142	-149	-156	-760	-905
Income Tax Revenue	42	36	36	37	39	190	226
Allowing Interest on Reserves	-125	-110	-106	-112	-117	-570	-679

Interest Payments on Reserves Projected Under Current Law. Because depository institutions currently do not earn a return on required reserve balances, they have an incentive to minimize such balances. Required reserve balances measured almost $30 billion at the end of 1993, but have since fallen sharply to under $7 billion today. The widely reported expansion of consumer and business sweep accounts have caused this decline. In typical sweep accounts, banks shift their depositors' funds from demand deposits, against which reserves are required, into other depository accounts, against which reserves are not required. The banks shift the funds back to the demand deposit accounts the next business day, or when needed by the depositor. Sweep accounts for business demand deposits have existed in various forms since the early 1970s. Recent advances in computer technology have now made the shifting of funds feasible for many consumer accounts as well. Under current law, CBO expects the expansion of retail and business sweep accounts to continue and required reserve balances to decline further to about $4 billion by 2003. Thereafter, CBO projects them to rise gradually with growth in the economy.

The Federal Reserve would be allowed to choose the interest rate it pays on reserve balances, although the rate chosen could not exceed the general level of short-term interest rates. Staff at the Federal Reserve have indicated that the Federal Reserve would choose an interest rate near the key short-term rate, the federal funds rate. The likely rate would be 10 to 15 basis points lower than the federal funds rate to account for the lack of risk. Accordingly, CBO assumes that the Federal Reserve would pay interest only on required reserves and clearing balances at a rate of 10 to 15 basis points below the federal funds rate.

CBO projects that the federal funds rate will average about 5.0 percent over the 10-year period from 2002 through 2011. The payment of interest on reserves is assumed to start early in fiscal year 2002. CBO projects that SBICA would cause the Federal Reserve to pay interest to depository institutions of about $185 million in 2002 on the $4.25 billion of *required* reserve balances expected under current law. Over the 2002-2006 period, such interest payments would total approximately $1 billion. Those payments would reduce the profits of the Federal Reserve–and thus its payment to the Treasury–by the same amount.

Projected Impact of the Bill on the Volume of Reserves. If the Federal Reserve pays interest on *required* reserve balances, there would be a second budgetary effect on the Federal Reserve that would reduce–but not eliminate–the net revenue loss from the payment of interest. In particular, based on a survey by the Board of Governors of the Federal Reserve System, we would expect reserve balances to increase because depository institutions would close a significant share of their retail and business sweep accounts and, as a result, maintain a higher level of required reserves. The payment of interest on business demand deposit accounts coupled with the payment of interest on reserves gives both businesses and depository institutions an incentive to open business checking accounts and close wholesale sweep accounts. Under current law, depository institutions are already allowed to pay interest on consumer demand deposits. By closing a significant share of consumer and business sweep accounts, depository institutions could eliminate the costs of maintaining the sweep accounts and receive a return on their required reserves, although presumably at a lower rate than what they could receive with alternative use of the funds.

CBO assumes that depository institutions would eliminate approximately 30 percent of both retail and business sweep accounts currently in existence by 2002, and half of those that otherwise would be established. Although the payment of interest on business demand deposits by depository institutions would not be permitted until two years after enactment of H.R. 974, the act would allow businesses to establish interest-bearing transaction accounts. Businesses would be allowed up to 24 transfers per month (or greater if the Federal Reserve permits) into a demand deposit account that would be subject to reserve requirements. Because reserve requirements would also apply to those accounts, they would be similar to interest-bearing demand deposits. As a result of the closings of retail and business sweep accounts, demand deposits on which required reserves are calculated would increase at depository institutions. CBO projects that required reserve balances would increase above the level expected under current law by about $12 billion by 2006. Although the Federal Reserve would pay interest on the added reserves at approximately the federal funds rate, it would invest the reserves in Treasury securities, earning a rate of return in excess of the federal funds rate by approximately 0.40 of a percentage point. As a result of the rate differential, the Federal Reserve would generate additional profits of about $261 million through 2006 and remit them to the Treasury as governmental receipts.

Projected Impact on Income Tax Revenues. Allowing interest on *required* reserve balances held at the Federal Reserve would have a third budgetary effect that would also reduce–but not eliminate–the decline in revenue from the payment of interest on current balances. The net effect of interest payments on reserves and the anticipated shift to more demand deposit accounts is expected to be a reduction in the profits of the Federal Reserve and an increase in the profits of depository institutions or their customers, with a consequent increase in income tax revenues. CBO assumes that the profits of depository institutions or their customers would increase by roughly the same amount that the profits of the Federal Reserve decline. It is likely that, instead of retaining the additional interest income from the Federal Reserve, depository institutions would pass through some of the increased profits to their consumer and business customers by, for example, raising interest rates on deposits or lowering rates on loans. If a complete passthrough did occur, then the customers–not the depository institutions–would accrue the income and pay additional taxes. Although some of the additional interest income of depository institutions may be passed through in nontaxable form either to their customers or to nontaxable entities, this amount is expected to be negligible. CBO assumes that depository institutions and their customers face an average marginal tax rate on income of 25 percent and estimate that income tax receipts would increase by about $42 million in 2002 and approximately $190 million through 2006.

The Allowance of Interest on Contractual Clearing Balances. As discussed previously, staff at the Federal Reserve have indicated that, given the authority, the Federal Reserve would give depository institutions the option of earning an explicit rate of interest on *contractual clearing* balances or continuing with the current system of earning an implicit rate of interest in the form of an interest credit. CBO estimates that giving depository institutions the option of earning an explicit rate of interest on contractual clearing balances would have little or no budgetary effect. For those depository institutions choosing to earn an explicit rate of interest on contractual balances, the explicit interest earnings, for the most part, would be substituted for what is now an implicit interest payment. Earning an explicit rate of interest on contractual balances may give some depository institutions an incentive to hold somewhat higher balances than currently because the interest credit earned under the present system can only be used to offset user fees for services provided by the Federal Reserve. A number of banks are already able to cover all of their service costs this way, so that an explicit rate of interest is required to give them an incentive to hold more reserves. As with required reserve balances, the Federal Reserve would pay an interest rate near the Federal funds rate on these additional contractual balances and invest the funds in Treasury securities which normally earn a higher return. The difference between what the Federal Reserve pays in interest on these additional balances and what it earns by investing them in Treasury securities would result in an increase in Federal Reserve earnings. Depository institutions, however, may choose to increase their contractual clearing balances by reducing the excess reserve balances they hold at the Federal Reserve. The Federal Reserve currently pays zero interest on excess reserves and invests them in Treasury securities, remitting these earnings to the Treasury. The additional earnings on contractual clearing balances could be completely offset, or possibly more than offset, depending on the extent to which depository institutions choose to increase their clearing balances by reducing their excess reserve balances. For example, if clearing balances increase by $2 billion and the rate differential between the fed funds rate and Treasury securities is 0.50 percentage points, then Federal Reserve earnings would increase by $10 million. If, however, $200 million of the increase in clearing balances was the result of a transfer from excess reserves by depository institutions, then, assuming a rate of return on Treasury securities of 5 percent, Federal Reserve earnings would not change because the $10 million increase in earnings would be offset by a decline of $10 million from the investment of excess reserves. CBO, therefore, estimates that offering an explicit interest rate on contractual clearing balances is likely to have little or no significant effect on earnings.

Transfer from Surplus Funds of the Federal Reserve

During the first five years SBICA would be effective (fiscal years 2002 through 2006), the legislation provides that the revenue loss associated with allowing interest payments on reserve balances would be offset by requiring the Federal Reserve to remit from its surplus fund to the Treasury an amount equal to an estimate of the annual net revenue loss. In addition, during this same five-year period, the bill would make the Federal Reserve payment of net earnings to the Treasury mandatory and the Federal Reserve would not be allowed to replenish its surplus fund. Those provisions would have the effect of reducing the cost of the legislation to zero for the first five years the bill is in effect and postpone the accumulated net revenue loss to the federal government to the sixth year, 2007.

Out of its annual earnings, the Federal Reserve covers its operating costs, pays a small dividend to its member banks, retains monies for its surplus fund, and voluntarily remits the remaining profits to the U.S. Treasury. The Federal Reserve's surplus fund is a stock of retained earnings accumulated over time and is set by the Federal Reserve banks each year at a level equal to the paid-in capital of its member banks. The fund can be used as collateral for issuance of Federal reserve notes and may be viewed as a fiscal cushion. The surplus funds are invested in Treasury securities and the interest generated is remitted to the Treasury along with other profits of the Federal Reserve. During the first five years SBICA is in effect, the Federal Reserve would remit to the Treasury all of its earnings above its member bank dividend payments, addition to their surplus account, and operating costs, which would now include interest paid on reserves. In addition, it would be required to remit from its surplus fund an amount equal to the estimated payment of interest on reserves. The Federal Reserve would be prevented from replenishing its surplus fund by the amount of these transfers during this five year period and its payment of net earnings to the Treasury would be mandatory. In fiscal year 2007, however, the Federal Reserve would be expected to replenish its surplus fund by the entire amount that was transferred from the fund to the Treasury during the 2002-2006 period, an estimated $570 million. This response is anticipated because the Federal Reserve has replenished its surplus account at its first available opportunity with past legislated surplus fund transfer payments. The legislated surplus fund transfer under SBICA, therefore, has the effect of postponing the accumulated net revenue loss to the Treasury during the first five years the legislation is in effect until the sixth fiscal year, 2007. CBO estimates that the revenue loss in fiscal year 2007 would be about $693 million. The Federal Reserve would be expected to retain $570 million out of its earnings to replenish its surplus fund instead of remitting these profits to the Treasury. The remaining $123 million is the estimated net revenue loss of allowing interest payments on reserve balances for that year. CBO estimates that the resulting revenue loss for the 2007- 2011 period would be approximately $1.2 billion.

The transfer of the surplus funds does not reduce the cost of the bill to the federal government over the long term, it just postpones it. It also is important to note that the transfer of surplus funds from the Federal Reserve to the Treasury has no import for the fiscal status of the Federal government. If the surplus funds are held at the Federal Reserve, they are invested in government securities and the interest generated is remitted to the Treasury. If the surplus funds are transferred to the Treasury instead, they reduce the public debt and in turn the interest payments owed by the Treasury. Since the interest payments would be identical in either case, where the funds reside has no *economic* significance. Hence, any transfer of the Federal Reserve surplus fund to the Treasury would have no effect on national savings, economic growth, or income.

Payment of Interest on Business Demand Deposit Accounts

The repeal of the prohibition on depository institutions of paying interest on business demand deposit accounts would, in itself, have the effect of increasing demand deposit accounts at depository institutions, although CBO estimates that this effect would not be significant without the additional provision of allowing interest on required reserves. Depository institutions that do not currently offer commercial sweep accounts would offer interest-bearing business demand deposit accounts and businesses that currently have sweep accounts would have an incentive to hold higher levels of demand deposits with the allowance of interest on business demand deposits. Required reserves held at the Federal Reserve would increase with the rise in the level of demand deposits, increasing the earnings of the Federal Reserve and the amount that is remitted to the Treasury as governmental receipts. CBO, however, estimates that the revenue effect of that increase in required reserves would be negligible and that it is the combined effect of the payment of interest on reserves and the allowance of interest on business demand deposit accounts that result in the revenue loss described above.

Provisions in the Bill Estimated To Have An Insignificant Budgetary Effect

CBO estimates that there would be no budgetary effect from the provision that gives the Federal Reserve additional flexibility in setting reserve requirement ratios by removing the lower limits on the ranges of allowable ratios. Federal Reserve staff have indicated that no policy change would be likely to occur as a result of enacting that provision in the current economic environment. The bill would require the Federal Reserve to conduct a survey of insured depository institutions and credit unions and submit an annual report to Congress on the availability and cost of banking services. Since the Federal Reserve currently collects this information, albeit on a smaller scale, CBO estimates that the additional costs to the Federal Reserve would be insignificant. In addition, based on information from the Federal Deposit Insurance Corporation, CBO estimates that the bill would have no significant impact on the total balance of insured deposits or the likelihood that some institutions would fail and, therefore, would have no significant impact on federal spending.

PAY-AS-YOU-GO CONSIDERATIONS

The Balanced Budget and Emergency Deficit Control Act sets up pay-as-you-go procedures for legislation affecting direct spending or receipts. CBO estimates that H.R. 974 would not affect receipts over the 2002- 2006 period, but would reduce receipts by $1,249 million over the 2007- 2011 period, as shown in the following table. For the purposes of enforcing pay-as-you-go procedures, only the effects in the budget year and the succeeding four years are counted.

	By Fiscal Year, in Millions of Dollars									
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Changes in receipts	0	0	0	0	0	-693	-130	-135	-142	-149
Changes in outlays	Not applicable									

ESTIMATED IMPACT ON STATE, LOCAL, AND TRIBAL GOVERNMENTS

H.R. 974 contains no intergovernmental mandates as defined in UMRA and would impose no costs on the budgets of state, local, or tribal governments.

ESTIMATED IMPACT ON THE PRIVATE SECTOR

H.R. 974 would authorize the Federal Reserve to pay interest on required reserve balances held on deposit at the Federal Reserve. The bill also would authorize the Board of Governors of the Federal Reserve System (FRB) to prescribe regulations concerning the responsibilities of correspondent banks that maintain balances at the Federal Reserve on behalf of other institutions. Such private institutions as commercial banks, Federal Home Loan Banks, and Corporate Credit Unions serve as correspondent banks for many depository institutions that are not members of the Federal Reserve. Based on information provided by the FRB, CBO anticipates that the FRB would not use its authority to issue regulations unless problems arose in the crediting and distribution of interest earnings. Thus, CBO expects that this bill would not impose a mandate as defined by UMRA on the private sector. If after a period of time the FRB determined a rule was necessary, the FRB indicates that the form a rule would most likely take is to require that correspondent banks pass the interest earnings back to the institutions for which they maintain required balances at the Federal Reserve. The cost to the correspondent banks of complying with such a rule would be negligible.

H.R. 974 would require the Federal Reserve to pay interest on required reserve balances held on deposit at the Federal Reserve. The bill would also authorize the Board of Governors of the Federal Reserve System (FRB) to prescribe regulations concerning the responsibilities of correspondent banks that maintain balances at the Federal Reserve on behalf of other institutions. Such private institutions as commercial banks, Federal Home Loan Banks, and Corporate Credit Unions serve as correspondent banks for many depository institutions that are not members of the Federal Reserve. Based on information provided by the FRB, CBO expects the FRB would not use its authority to issue regulations unless problems arose in the crediting and distribution of interest earnings. Thus, this bill would impose no new private-sector mandates as defined by UMRA. If after a period of time the FRB determined a rule was necessary, the FRB indicates that the form a rule would most likely take is to require that correspondent banks pass the interest earnings back to the institutions for which they maintain required balances at the Federal Reserve. The cost to the correspondent banks of complying with such a rule would be negligible.

ESTIMATE PREPARED BY:

Federal Revenues: Carolyn Lynch (225-6510)

Impact on the Governmental Sector: Susan Sieg Tompkins (225-3220)
Impact on the Private Sector: Patrice Gordon (226-2940)

ESTIMATE APPROVED BY:

G. Thomas Woodward
Assistant Director for Tax Analysis

Bob Sunshine
Assistant Director for Budget Analysis

April 3, 2001

Honorable Michael G. Oxley
Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20510

Dear Mr. Chairman:

The Congressional Budget Office has prepared the enclosed cost estimate for the Small Business Interest Checking Act of 2001.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contacts are Carolyn Lynch (for revenues), who can be reached at 225-6510 and Patrice Gordon (for the private-sector impact), who can be reached at 226-2940.

Sincerely,

Dan L. Crippen

Enclosure

cc: Honorable John J. LaFalce
Ranking Minority Member